

**Bulletin 58B**

**DISCOUNTING OF MEDICAL MALPRACTICE LOSS RESERVES**

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The purpose of this Bulletin is to address the concept of loss reserve discounting and to provide a position by the Department of Insurance on this subject in accordance with the Tax Reform Act of 1986.

Loss reserve discounting was made mandatory for the calculation of taxable income by means of s 846 of the tax code. Discounting became effective in 1987 on loss payment patterns for all property and casualty loss reserves in calculating taxable income. Discount factors established at a five (5) year average treasury rate are applied to loss and loss adjustment reserves including incurred but not reported. Discount rates for pre-1988, 1988, and 1989 are 7.20%, 7.77%, and 8.16%, respectively. An increasing discount rate results in a higher reserve discount.

Casualty reserves are paid over a period of time and are accounted for on a statutory basis using the gross payout principle. Therefore, for each loss year, the future total payout is accounted for as incurred and a full reserve must be established. Loss reserve discounting factors the time value of money by calculating the present value of reserves outstanding. In applying a reserve discount, the difference or reduction in realized loss creates an increase in net income. Accordingly, an increase in realized income for tax purposes creates a higher tax liability.

The difference in recognizing the tax expense under GAAP for financial statement presentation and calculating FIT under IRS rulings results in deferred income tax. Portions of the deferred tax are recognized and expended over periods of time under GAAP. Statutory accounting principles do not allow or recognize deferred tax and therefore all taxes calculated under FIT rules are expended on the statutory income statement in the current period.

Loss reserve discounting has the greatest impact on the longest tail lines. While there are many lines of liability coverage which have extremely long payout patterns, medical malpractice receives the highest discount factors in comparison to any other Schedule P reserves.

Therefore, this Department is broadening its position and will allow discounting of medical malpractice loss reserves, using a discount factor to be determined by the Commissioner of Insurance, beginning with the 1989 annual statements which are due by March 1, 1990. The amount of discount shall be fully disclosed in the footnotes to the financials. Any company writing medical liability insurance that intends to discount its reserves should contact the Financial Services Division of the Department of Insurance for the maximum level of discount available for annual statement preparation.

John J. Dillon III  
Commissioner